Issue three hundred and forty

End of an era: PM Abe steps down

Japanese prime minister Shinzo Abe has stepped down, his term cut short by illness, drawing to a close a period as one of Japan's longest serving leaders. Abe brought with him hope of marked changes when he first launched "Abenomics", aiming to re-anchor inflation at 2%, boost potential growth and reassert Japan's standing in Asia. The moves by the Bank of Japan were radical at the start, and have been very aggressive overall, but they have had a marked impact on the Japanese stock market.

Back in September 2013, he rang the bell for the start of trading at the New York Stock Exchange and exhorted investors to "buy my Abenomics", referring to the package of reflationary measures that he had introduced at the start of that year.

It was a bold calculated bet, establishing that the performance of the Japanese stock market would be a crucial measure of Abe's success. No previous Japanese leader had elevated the stockmarket in such terms. Indeed, politicians in most countries are wary of commenting on stockmarkets because their gyrations are so unpredictable.

In normal circumstances, such caution is sensible. But when the Abenomics bull market started in November 2012, economic conditions in Japan were anything but normal. After two decades of chronic financial crisis and deflationary stagnation, Japan's nominal GDP was no higher than it had been twenty years previously and the TOPIX index of stock prices was languishing at roughly the same level as in 1983. As far as international investors were concerned, Japan had dropped off the radar screen.

Put simply, Abe's plan of resurrecting Japan as a confident, independent geopolitical player would never succeed without economic revival – and that could not happen without a decisive end to the long-drawn-out bear market in stocks.

So now that the Abe era is coming to an end, how does his record stack up? Between December 2012 and September 2020, the TOPIX has produced a total return of 140% in local currency terms which looks highly creditable. Furthermore, the rise in Japan's stockmarket has been driven by improved corporate fundamentals, not any inflation of valuations. From 1954 to 2012, Japanese profit margins moved in a 1% to 4% range, which is exceptionally low by international standards. But as of 2019, margins had soared to 6%. The biggest improvement was not in the export sector, but among the overwhelmingly domestic non-manufacturers, as sectors such as construction stopped taking on low-margin work.

The valuations speak for themselves. Until Covid-19 burst upon the scene, the TOPIX's price/earnings ratio was at 50-year lows. The current price/book-value ratio of 1.17 tells a similar story. And Japanese book value is mainly backed by tangible assets, including a vast stockpile of cash, rather than the "goodwill" from M&A activity and other intangibles that makes up 70% of US book value.

Likewise, for the first time in living memory, Japanese stocks are offering a solid real dividend yield of 2.4%. Pre-Covid, this was enhanced by share buybacks amounting to between 1% and 2% of market capitalisation. Japanese pay-out ratios are still low by European standards, so more progress is likely if and when corporate confidence recovers from the Covid shock.

Abe was not directly responsible for all these changes in corporate behaviour, but his espousal of governance reforms changed the weather in terms of the relationship between company managements and investors. Japan's stewardship code and governance code are not compulsory, but peer pressure is a powerful force.

Today, nearly all listed companies have investor relations departments, and most are willing to answer in-depth questions about company operations. This was far from the case in the early years of this century. In a poacher-turned-gamekeeper move, some companies have recruited ex-investment bank personnel to staff their IR departments. A few are foreigners, which, again, would have been unthinkable in former times.

Abe also converted the Government Pension Investment Fund from a sleepy backwater, whose main function was hoovering up Japanese government bonds, into a sophisticated multi-strategy asset manager. The GPIF, usually reckoned to be the world's largest pension fund, is now a trailblazer for governance reform and ESG principles in Japan and a role model for other domestic pension funds.

Abe's record is by no means flawless. Two unnecessary hikes in the consumption tax, the last enacted just as the Covid virus was emerging in China, crushed the economy's reflationary momentum. Inflationary expectations – as measured by five-year inflation swaps – have round-tripped from sub-zero to 1.4% and back again. All the monetary policy innovations of Bank of Japan governor Haruhiko Kuroda were for nothing without expansionary fiscal policy working in tandem.

Overall, though, Abe leaves Japan's investment scene in far better shape than he found it. If his successor continues in the same vein – hopefully adding fiscal policy to the mix – investors should be well pleased.

Market Snapshot (28.08.20 – 04.09.20)

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FTSE 100	5799.08	↓2.76%	UK	0.25	↑19.05%	£/$	1.3283	↓0.52%	Brent Crude	$42.35	↓6.08%
S&P 500	3426.96	↓2.31%	US	0.72	↑12.50%	£/€	1.1220	↑0.04%	Gold	$1921.30	↓2.05%
NIKKEI 225	23205.43	↑1.41%	Germany	-0.48	↑6.27%	€/$	1.1840	↓0.55%			
DAX 30	12842.66	↓1.46%	Japan	0.05	↓66.67%	£/¥	141.1200	↑0.31%			
CAC 40	4965.07	↓0.76%									

Figures quoted are in local currency
Source: FE Analytics & Financial Times

Week Ahead

Monday – Japan: GDP (QoQ) (Q2)
Tuesday –
Wednesday – US: JOLTs Job Openings (Jul)
Thursday – Euro Area: Deposit facility Rate (Sep)
Friday – UK: GDP (YoY)

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